Schmieding, Holger

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Lending stability to Europe's emerging market economies: On the importance of the EC and the ECU for East-Central Europe

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by Holger Schmieding

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I. Introduction

The standard literature lists three ways in which the Western industrialised countries could support the transformation process in Europe's emerging market economies (EMEs): technical assistance, financial aid and trade access (see i.a. World Bank 1991, p. iv). Important as such support would be, it may not suffice. This paper adresses the question whether the West could make a further major contribution: lending institutional stability to the EMEs. The starting point is the observation that an institutional deficiency or even void is one of the major causes of the transformation crisis.[1] The old institutions have largely vanished; the emergence and consolidation of new and ultimately far superior institutional arrangements takes time; the nascent local institutions lack stability and credibility. Whereas the issues of credibility and institutional stability have featured prominently in the debate on some internal aspects of the transformation process, they have played no major role in the discussion on how the West could support the EMEs and how East-Central Europe could and should be incorporated into the process of European integration.

The major conclusions are that established Western market economies have a comparative advantage in the supply of stable and credibly institutions. The EMEs lack an appropriate internal technology for making credible precommitments. The opportunity to join the EC and to link their currencies irrevocably to a Western currency (preferably the ECU) would give them an external precommitment technology and lend credibility to the new economic

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1) This point is elaborated in more detail in Schmieding (1991b).

regime. With regard to the EC, an association agreement which specifies a date for full membership would be a close substitute for immediate accession. With respect to monetary arrangements, a simple unilateral peg of the EME currencies to the ECU would not suffice. Instead, the EMEs could gain considerably if they entrusted their monetary policy to a Western central bank.

2. Conceptual Issues

In this paper, institutions are defined in a broad sense, i.e. as encompassing not only bureaucracies and administrations but also - and more importantly - transaction-cost reducing social devices such as money and the entire body of laws, rules, regulations and patterns of behaviour which constitute the non-budget constraints under which economic agents can pursue their own individual ends. The decisive feature is not the legal status of such a social device but its power to shape individual behaviour, notably in the sense of contributing to a coordination of individual activities at low transaction costs. An essential part of an institution in this sense is what may be called institutional capital, namely (i) the accumulated institution-specific human capital of both the individuals who operate an institution - say central bankers in the case of the monetary system - and of the individuals subject to this institution (i.a. users of the money) and (ii) the reputation and credibility of the institutions.

Fortunately, market-conformable institutions do not have to be re-invented or to be built from scratch in the EMEs. Such institutions already exist in the advanced Western market economies. The ways in which the EMEs could benefit from this fact depend on the features of the institutional arrangement concerned:

(1) With regard to <u>laws, regulations</u> and similar institutional features that are consciously shaped by the legislative or the executive bodies of the state, the EMEs could simply use a Western model as a blueprint. They could even copy a model wholesale. Naturally, this raises the problems which of the

various arrangements of the different Western countries is best for a developed market economy and whether these arrangements fit the special needs of the EMEs in the transition period (see section 7).

(2) Even public administrations and other institutions that implement and police laws and regulations may to some extent be imported from the West, for instance under the heading of "technical assistance". The available supply of suitable Western administrators and advisors who are familiar with local customs - and the local language - may be rather limited though.

(3) The process of acquiring institutional capital in the sense of getting acquainted with new laws and regulations can also be facilitated by copying Western arrangements. This holds under the assumption that economic agents can accumulate knowledge on an institutional arrangement more easily if - as a complement to their own current observations - they can draw on experiences which have been gathered with the same arrangement elsewhere.

(4) In a similar vein, the adoption of an institutional arrangement which has proven its internal consistency in the West enhances the trust which economic agents place in the same arrangement in an EME. A near-certainty that an institutional arrangement is at least internally consistent removes one of the possible causes for doubts about whether and for how long the institutional innovation will last in its current form. Internal consistency does not necessarily mean that the arrangement is appropriate for the transformation period in the EMEs or that it conforms to other institutional arrangements that have evolved locally or have been modelled in the image of a different Western country. For example, a banking system of the U.S. type may not fit with German-type capital market laws and regulations. Hence, the probability of future institutional changes to correct such inconsistencies is only reduced but not eliminated by opting for some Western blueprints.

Even in cases in which apparently optimal institutions might be established by the stroke of a pen, for instance by drawing on Western experience and creating an independent central bank compelled by law to safeguard the internal value of the currency, the extent to which such institutional innovations succeed in influencing private - and government - behaviour depends on the public perception of their credibility. Being new, such central banks lack the anti-inflationary reputation which arises from a history of resisting short-term incentives for loosening the monetary reigns. Hence, the issues of institutional stability and credibility go far beyond the considerations of internal consistency mentioned above.

3. The Importance of Credible Institutions

Credibility problems can refer to various levels of the future institutional environment. Economic agents may have doubts about

- the future economic order (will a market economy in fact be introduced and maintained?),
- the future shape of individual institutions (will there be an independent judiciary, an independent central bank...?),
- specific policies (which company law, how will the law be applied, what will the monetary stance be...?)

On the one hand, uncertainty may arise from insufficient knowledge about the intentions and resolve of the present decision makers who design institutional arrangements. On the other hand, uncertainty may stem from the possibility of a change of decision makers. Furthermore, even in the absence of such uncertainties, an announced policy may simply lack credibility because it is time inconsistent or, to be more precise, subgame imperfect. A lack of credibility causes three different kinds of costs to individual agents and the economy as a whole, two of which relate to uncertainty and one to genuine time inconsistency:

(1) Because of uncertainty, the pattern of economic exchanges is less complex than it could be otherwise. Economic agents

continually make choices which are shaped by expectations based on ex-ante available information. Typically, these choices cannot be undone costlessly. Resources may have been devoted irrevocably to certain uses, foreclosing alternative opportunities which had been available ex ante; for reasons of transaction costs, contracts with a time dimension may be reneged only periodically. Hence, the reliability of the ex-ante information in general and, more specifically, the subjective probabilities with which economic agents expect any institutional arrangement to apply in the future matters. The more certain economic agents are about future institutional arrangements, the more will they be willing to invest resources into specific uses, to conclude contracts that are not subject to costly instant change and to engage in an extended division of labour.

(2) To reduce uncertainty, rational economic agents will incur costs of gathering information until the expected marginal benefits equal the marginal costs of obtaining a further unit of information. Besides these individual costs of what may be called passive learning, economic agents have an incentive to find out about the institutional arrangements by deliberately putting them to a test (active learning). Consider the calculus of special interest groups in a game against government. If these groups knew for certain that the government will not dispense special favours (sector-specific protection, subsidies) at the expense of overall economic efficiency under any circumstances, these groups would not waste resources to clamour for such favours. As long as these special interest groups are not certain about the stance of government, all of them have an incentive to test the resolve of government to the limit. Not or not yet knowing for certain how government will react under pressure, workers of state firms will rationally weigh the expected probability of getting higher real wages and of eliciting subsidies via strikes or other industrial action against the risk that the strikes might fail and even put some of their jobs at risk. The weaker the government and the greater the uncertainty both about its genuine objective function and about its resolve under pressure, the more incentive do special interest groups have to engage in such negative-sum

games.[2] Naturally, such uncertainty is particularly pronounced during a revolutionary transformation of the entire body politic and economic, i.e. in the present situation of the EMEs. Weak institutions are an invitation to pursue negative-sum games. Those economic agents who do not join in run the risk of being exploited by everybody else, i.e. to be the ones on whom a disproportionate share of the overall costs is shifted.

(3) Time inconsistency causes costs in the sense that economic agents fail to attain the social optimum. Such problems arise when one player in a game has to move prior to another player in a setting in which the social optimum and the Nash equilibrium diverge. Once the first mover has irrevocably made his choice based on the social optimum, the ex-post constraints for a further player - for whom the social optimum is only the second best outcome - differ from the ex-ante constraints. The second mover can now opt for his first-best outcome at the expense of the first mover. Anticipating such a behaviour, a rational first mover will not aim at the social optimum in the first place but adopt a socially undesirable defensive strategy. This leaves both players worse off than if they had strived for the social optimum. Take the standard example of agents who would both benefit if one agent could extend a credit to the other one. Ex ante, it is clearly rational for the potential borrower to promise repayment (including interest). However, once the borrower has got the credit (i.e. ex post) he is better off if he does not repay. Knowing about this skewed ex-post incentive, the potential lender will not grant the credit. The time-consistent (subgame perfect) outcome is not optimal while the social optimum is time-inconsistent (subgame imperfect).

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2) A closely related point refers to the importance of legitimacy; Polish citizens reacted very differently to price increases under the old Rakowski government and under the new legitimate Mazowiecki government.

The standard solutions for inconsistency problems can be grouped into two classes: (i) the pay-off matrix of the game is manipulated so that the Nash equilibrium changes as to coincide with the social optimum in the single game under consideration, or (ii) the one-shot game is embedded in a supergame, i.e. in a series of similar games with the same players so that the first mover (in the original game) can punish the second mover for misbehaviour in further rounds. Anticipating this, the first mover may behave in a socially optimal way from the very beginning.

Consider the second case first. What turns a single game into a supergame is not the mere fact of repetition. If all games were identical, the second mover could promise to behave in each subgame and always renege afterwards (Chari et al. 1989). The point about repetition is the element of history contingency. The first mover makes his action dependent on the past behaviour of the second mover. Under conditions of uncertainty[3)], the information on which the players base their decisions evolves over the course of time. Observing the actual behaviour of others in every round yields information about their preferences. In other words: players establish a reputation; the longer and/or the more clearly they have refrained from opportunistic behaviour, the more credible is their promise to go for the social optimum - which makes it increasingly rational for the first mover to do so as well. If the supergame is played with an infinite or an uncertain time horizon, if the future punishment for opportunistic behaviour is sufficiently harsh and credible and if the factor by which the potential opportunist discounts future pains is sufficiently small, the second mover will choose the social optimum strategy.

Considerations of reputation can be seen as an elegant and flexible means to get around problems of time inconsistency.

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3) More precisely: imperfect knowledge about the preferences of other actors and the present and future states of nature.

Formal models employing reputation, however, do not yield very relevant or robust results. Many models have multiple equilibria, depending i.a. on the lengths of the "punishments" (Rogoff 1989); knowledge about multiple equilibria does not help economic agents very much who have to choose one real-live strategy now. Even in specifications with a unique equilibrium, the properties of the solution are sensitive to the assumptions about information (Rogoff 1989). This point is obvious: If the problem of time inconsistency is aggravated by uncertainty about the policymaker's objectives or about the costs which the policymaker attaches to a loss in reputation, the other players have little reason to base their actions on the assumption that government and administrations (the second movers) will resist temptations for exploitation.

Unfortunately, the very argument that players will behave because they cherish their reputation is particularly unconvincing for EMEs. Concern for reputation has two aspects, namely that of safeguarding an established reputation and that of acquiring a future reputation. By definition, the new politicians and administrators have little established reputation to draw on. And with regard to a supposed concern for future reputation, economic agents may assume that the time horizon of governments in the upheavals of the transformation period is rather limited (i.e. government is perceived to discount the future by more than would be normal elsewhere). In a similar vein, the uncertainty about who might replace the present actors is particularly pronounced in the transformation period so that rational economic agents will have a strong incentive to hedge their bets. In other words: the reputation of the local actors in the EMEs is unlikely to play even the limited role which it can elsewhere.

Paradoxically, a pronounced concern for future reputation may even have adverse short-run implications if an institution needs to convince economic agents of its true nature by deeds rather than mere words. Consider the case of a new central bank whose directors are genuinely committed to price stability. In order to establish their anti-inflationary credentials, these directors will rationally invest in reputation by adopting a monetary stance that is more restrictive in the beginning than it would be if the central bankers were already satisfied with their reputation. While this increases the probability that economic agents correctly interpret the central bankers' behaviour as evidence of a genuine commitment to be tough on inflation, it initially adds a further element of a money-induced recession to the present transformation crisis. To signal their resolve in all future crises, new central bankers may have an incentive to engineer one immediately. This point can be generalized: The less reputation the new institutions have, the smaller is their scope for reacting flexibly to unforeseen challenges over the course of the transformation process without jeopardising the credibility and hence effectiveness of the transformation programme as a whole.

As a close substitute for reputation, a promise to stick to the social optimum strategy can be made more credible and hence beneficial by changing the pay-off matrix of the potentially opportunistic player in a single game. If a means can be found to reduce the opportunistic gain below the reward which the second mover gets from the social optimum strategy anyhow, he can credibly precommit himself to the latter strategy by subjecting himself to the punishment for opportunism (i.a. by the use of hostages or of a collateral, see Kronman 1985 for a survey). If a binding commitment to an ex-ante optimal policy is possible, the incentive for the second mover to deviate ex post is immaterial. Unfortunately, such commitment technologies are particularly hard to find for the dealings between state institutions endowed with sovereign rights as second movers and economic agents as first movers (Persson 1988). Being able to shape the rules of the local game, the sovereign state can hardly precommit itself credibly to accept a future internal punishment for opportunistic behaviour. And the damage which reneging would do to the reputation of the institution may not make much of a difference (see above). Note that, due to uncertainty on the part of the public about the true preferences of sovereign actors, these arguments apply even if the relevant politicians and administrators were in fact genuinely committed to attaining the social optimum and would hence voluntarily want to forego any chance for opportunistic behaviour. They simply have no appropriate precommitment technology at their disposal, at least not within their own country.

To sum up: the standard means for mitigating credibility problems are only of limited use in the transformation crisis in the EMEs, i.e. in a situation in which the need to make the nascent institutional arrangements stable and credible is particularly pronounced. If the new arrangements are insufficiently credible and perceived to be unstable, they will fail to shape individual behaviour in the desired way. This aggravates the transformation crisis - which in turn adds to the widespread doubts about the stability of the new institutions. The EMEs face the hazard of an institutional circulus vitiosus.

4. Borrowing Institutional Credibility from the West

The credibility problems refer to the current situation within the EMEs. In the ideal case, the EMEs would need

- an opportunity to draw on an established reputation,
- a technology for a credible precommitment, and
- a device for signalling the true preferences of the actors, whom the public under imperfect information may wrongly perceive as being susceptible to opportunistic behaviour.

While internal solutions are not readily available, the chance to team up with established institutions of Western market economies can provide an external solution. Remember that a simple internal decision to copy Western blueprints does not suffice (see section 2). Even if laws, regulations and administrative bodies were exact replicas of Western models, they would be less credible, stable and hence beneficial than in the West. Consider the issue in the terminology of a production problem. With an identical technology (laws, regulations, administrative bodies) and an identical endowment with one input factor (competent politicians and administrators with the same preferences as their Western counterparts), less institutional stability and credibility can be produced in the EMEs because these countries are less endowed with a further input factor, namely reputation. Because of differential endowments, the EMEs have a comparative disadvantage in the production of a credible and stable institutional environment. Hence, the EMEs would stand to gain if they could import either the missing input factor (reputation[4]) or the output (institutional stability)[5].

These considerations presuppose that reputation is internationally mobile and/or that institutional stability can be supplied beyond the confines of the geographic entity in which it has been produced. Consider a club whose rules demand that members behave in a certain way. By joining the club, members voluntarily restrict their freedom of action. If they cannot leave the club costlessly, their commitment to club-conformable behaviour is hence more credible than the mere announcement of an outsider to play by rules which are similar to those of the club. Institutional stability and credibility is supplied externally in the sense that the chance to join a club offers prospective members a superior way of precommitting themselves and of signalling their true intentions. If the EMEs can become members

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4) As reputation is something that is itself "produced" over the course of time, it would be more precise, albeit terminologically less convenient, to think of reputation as an intermediate product.

5) External suppliers of reputation would demand no compensation if their was no rivalry in the use of reputation. However, as a failure abroad is likely to impair the reputation of an institution in its home country as well, reputation will not be supplied across borders without a compensation. Such a compensation need not take the form of a tradable good or service. The greater freedom of action which the supplier of reputation gains by his ability to shape policy not only internally but also externally may be worth the risk. At least, he has greater knowledge and control about external developments which may have internal ramifications. Incidentally, this is one of the major reasons why Western states with comparatively close economic (or political) contacts with the EMEs are the natural choice among potential suppliers of reputation.

of an international club which puts comparatively sweeping demands on its members and for which the exit costs would be high, i.e. clubs like the European Community and/or the European Monetary System, the incentive for time-inconsistent behaviour and the public uncertainty about the future institutional arrangements would be dramatically reduced in the fields that are covered by the respective membership rules. In the extreme case, the authority to conduct policy in a specific field is not delegated to a common supranational body but to an institution on which the new member (i.e. the EME) has no influence at all.

An external commitment of this kind enhances credibility if a serious breach of the club rules (which might be punished by expulsion) increases the likelihood that such a deed will be noticed immediately and/or adds to the costs which policymakers have to incur in the case of a corresponding breach of a mere internal promise. The decision to join the club lifts the commitment to play by the rules to the level of constitutional choice. Joining and leaving the club are highly visible acts likely to be noticed by the voters. In other words: economic agents need to incur less information costs to find out about a major breach of discipline - and punish the misbehaviour at the time of the next election. Because the day-to-day policy will be monitored (or even conducted) by a credible external body, local economic agents need only inform themselves about the fact that their country has become and still is a member of the arrangement. They need not monitor the actual policy themselves to learn about the credibility of the institution. Furthermore, external monitoring means that a breach of discipline and hence the club rules is particularly embarassing. Opportunistic behaviour of local politicians and administrators would now entail the reneging of a promise not only to domestic citizens but also to foreign governments. This could impinge upon all aspects of international relations of the EMEs. Perhaps most importantly, the genuine popularity which the idea of "returning to Europe" seems to enjoy in Central and Eastern Europe implies that politicians and adminstrators in the EMEs will be particularly reluctant to break the rules of a European club to which their country has been admitted.

Note that the probability of punishment and hence the incentive to refrain from opportunistic behaviour is a positive function of the frequency of further transactions with the same players. In this respect, a multi-purpose club whose members deal frequently with each other on a wealth of subjects is superior to a single-issue club. Once a broad club like the European Community which covers many policy fields has been established, it is likely to exert a greater disciplinary pressure than, say, the narrower GATT.

5. Non-monetary Institutional Integration: The EC Link

Given the importance of intra-European economic exchanges and the cultural and historical proximity between Western Europe and the EMEs, the EC is the club to which the EMEs attach the greatest significance. The purpose of this section of the paper is to sketch how institutional links between the EMEs and the EC could enhance the probability that the EMEs will be able to adopt and maintain a sufficiently liberal regime for the non-monetary aspects of their international economic relations. The EC is taken as a club in which an (almost completely) free internal movement of goods and services, of capital and labour has been achieved (or will be achieved by January 1, 1993). Furthermore, countries are supposed to derive genuine political benefits from EC membership so that the cohesion of the club is even greater than pure economic considerations would suggest.

5.a. On the Logic of Liberalisation

To assess the importance of a regional club like the EC, first consider the political economy of liberalisation in a Western market economy[6]. The analysis is based on the premises that the abolition of barriers to cross-border transactions creates net benefits[7] and that these benefits are widespread among the members of society. If these assumptions hold, why then is protectionism nevertheless flourishing in the real world? Economists have two standard explanations. Both focus on asymmetries in the political process transforming individual preferences into collective policies:

First, rent-seeking interest groups can influence the outcome of this political process through payments or equivalent favours to established bureaucrats and politicians or to candidates seeking office. Admittedly, in a state of what may be called "perfect corruption", free trade would still emerge. As the gains from liberalisation exceed the losses, a coalition of free traders could always outbid a coalition of protectionists in the "political market". Unfortunately, due to the free-rider problem inherent in collective action (Olson 1965), a lobby representing the small number of individuals who expect to gain from a particular trade barrier is much more likely to emerge, to remain stable, and to extract the required resources from its members than any collective body of prospective losers, i.e. the large number of consumers and domestic producers who would be hurt by the intricate domestic and international repercussions of the protectionist measure.

Second, voters fail to elect enough free marketeers. Gains from a trade barrier tend to be concentrated on a minority of individuals who will thus take notice and vote accordingly, while the losses are so dispersed and unnoticeable that the majority of those who lose will remain in a state of rational ignorance

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6) The following paragraphs draw heavily on Schmieding (1988).

7) To put it somewhat technically: in the absence of transaction costs, beneficiaries could collectively compensate losers in such a way that, by their own standards, all individuals would end up better off than before liberalisation.

(Downs 1957). Due to this information cost calculus of voters, politicians and bureaucrats in a democracy can supply protection only to the extent that the negative effects do not surpass the threshold level at which it becomes rational for a majority of voters to devote time and effort to collecting information on these costs and to vote accordingly. This points to a major requirement for a feasible liberalisation strategy: if the gains are perceived as being sufficiently large, the voters are likely to back free traders. Thus a rational politician who would lose votes if he abolished just one particular barrier to international transactions has a strong incentive to create a link between a large number of liberalisation measures: the broader the package proposed, the more voters will rationally take the benefits into account.

As the log-rolling literature teaches, issue linkage is no guarantee for a free trade majority. By supporting each other, lobbies may form a coalition and help to enact a combination of state interventions that benefits more than half of the voters and severely harms the rest. The incentive to support such a distributional coalition, however, depends critically on what the individual voter knows about how he will be affected now and in the future: The closer a liberalisation package comes to a general and durable rule that international transactions shall be free, the less certain can any potential opponent be (i) that he, in his present position, will be a net loser, and (ii) that sometime in the future he might not assume a different position and turn into a beneficiary.

The greater the uncertainty about the present and future distributional consequences of liberalisation, the more will rational individuals identify the change in their personal fortunes with the expected per capita efficiency gains from liberalisation. If the "veil of uncertainty" (Brennan and Buchanan 1985) is thick enough, general rules instead of specific outcomes will be the subject of political discussion and choice. As the benefits from liberalisation exceed the costs, protectionists are most unlikely to carry the day.

Pursuing this constitutional approach means putting sweeping demands on the willingness of voters to acquire and process information about the overall effects of liberalisation. This may be a realistic option in times of a general awareness that drastic change is needed, i.e., in times of a deep crisis, or - oddly enough - in times in which the remarkable success of a recent liberalisation has drawn public attention to the issue. Under ordinary circumstances, that is in a situation in which voters have grown accustomed to the prevailing level of barriers to trade and factor movements, the mere proposal of a general rule that international transactions shall be free from state interventions is unlikely to mobilise sufficient support to overcome protectionist resistance.

Issue linkage may again offer a way out. The task is to devise a liberalisation package which, in addition to general gains, confers clearly visible benefits to a well-defined group of individuals as well. The most plausible way for a politician to achieve this is to link the reduction of national trade barriers to that of other countries so that domestic exporters can expect direct gains and act as a countervailing lobby against protectionist interest groups. Although a unilateral import liberalisation would promote exports as well, the benefits would be more dispersed and less certain than in the case of a reciprocal approach.

Since the gains from mutual liberalisation depend on the scope of the package, a global approach would obviously be best of all. The problems, however, of finding like-minded partners, striking a deal and devising ways of making it stick increase with the number of countries involved (Keohane 1984). The success of a strategy for reciprocal liberalisation depends on the present collaboration and future reliability of foreign politicians. The whole package deal could unravel if one participant defected, causing adjustment costs for those agents who have already adapted to the expected new trade regime. Hence, unless either a hegemon or a powerful supra-national authority is able to enforce a multilateral agreement, a liberal-minded politician may prefer to strive for a deal with a limited number of his country's major trading partners, at least as a first step towards a more far-reaching liberalisation.

So far, the analysis of the causes of protectionism and the logic of liberalisation has been restricted to considerations of political economy. As a supplement to this approach, neo-institutionalists stress the history-contingency of the pattern of protection. According to this approach, it is much more difficult politically to remove an old privilege than to resist granting a new one. Sectors which - for whatever reason - have managed to elicit protection, are likely to keep their special status (perhaps in a form which is modified over the course of time) unless a major institutional change occurs.

5.b. The EC as a Commitment to Liberalisation

With respect to the standard determinants of protectionism discussed above, the EMEs are almost uniquely well posed for a sweeping liberalisation of their internal and external economic relations.

(1) The element of history contingency is of comparatively little importance. The very essence of the political transformation is a revolutionary change in the previous arrangements which disposes of many inherited claims.

(2) As the need for drastic changes is obvious, notably that for a dramatic reduction in state interventionism, liberal-minded politicians can get around the "rational ignorance" of voters comparatively easily. They need not try to attract the attention of voters to the arcane issue of changing an institutional setting to which the public has grown accustomed. As a thorough change in external economic policy is clearly on the agenda anyhow, they merely need to explain the overall merits of a liberal regime. The crisis saves information costs; it helps to make voters aware of the issues.

(3) In a similar vein, the uncertainty about how the individual welfare will be affected in the medium and long run by a thorough liberalisation of cross-border transactions is likely to be much more pronounced during the general upheaval of the transformation process than would be the case in an established market economy. Hence, the EMEs are as close as one may ever get to a state in which decisions on allocational efficiency can be taken behind a "veil of uncertainty" about the precise distributional consequences.

(4) Special interest groups (lobbies) play only a minor role for the time being in the EMEs. The old elites are so discredited as to wield little political influence;[8)] new special interest groups are not yet capable of major collective actions as they are still in the process of organizing themselves. Powerful distributional coalitions of the sort which make liberalisation such an arduous undertaking in mature Western democracies have not yet emerged.

(5) Given the vast scope for expanding intra-European economic exchanges, reciprocity at least with the major partner of the EMEs, i.e. the EC, would further add considerably to the political feasibility of a sweeping liberalisation.

This is not the end of the story, though. An immediate liberalisation of all cross-border transactions may not be the

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8) The favourite occupation of the more innovative members of the old nomenclatura in the EMEs seems to be to turn capitalist via "spontaneous privatisations" or other means of plundering erstwhile state assets. Deplorable as this development may be on distributional grounds, it at least implies that these segments of the old elite no longer resist the systemic transformation. They even acquire a vested interest in the emergence of a capitalist system in which they could put their new private wealth to good use. Although Winiecki (1991) clearly had something different in mind when he argued for buying out the old nomenclatura, these "spontaneous privatisations" can be seen as such a bargain: the old nomenclatura gives up its previous political power and receives a compensation in material wealth.

first-best choice in sequencing a rational transformation programme. Instead, temporary protection of at least some sectors of the economy can be desirable in the initial phase for political or economic reasons. Although it may be hard to predict ex ante which sector will be threatened most, it is highly likely that some sectors will come under such pronounced competitive pressure as to make politicians willing to offer temporary protection. Furthermore, because of market failures in the transition period, notably the absence of a well-established capital market, it may make economic sense to grant temporary protection (or subsidies) to firms which may be viable in the long run but which are threatened with insolvency because they cannot get a sufficient amount of funds in a liquidity crisis.[9)]

The supply of such protection would however create unwanted precedents which would tend to undermine whatever credibility the whole liberalisation programme has. Furthermore, temporary provisions have a habit of turning into permanent arrangements (this can be interpreted as a further instance of the history-contingency of economic policy). Most importantly, special interest groups will increasingly succeed in overcoming their organizational problems over the course of time and turn into lobbies which are as powerful as their Western counterparts. Protectionist pressures are thus likely to grow stronger, jeopardising the liberal regime which may have been introduced in

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9) Even if there are convincing economic arguments for a temporary protection along the lines of the infant-industry argument, serious practical problems would have to be overcome. If the protection is supposed to be sector-specific, i.e. geared towards the sectors who suffer most from the imperfections of i.a. the internal capital market, a way would have to be found to identify these presently unprofitable but ultimately viable sectors. If the protection is to take the form of a uniform (or an almost uniform) tariff for all sectors - as has been proposed i.a. for the Soviet Union by Dornbusch (1990) and by the IMF et al. (1990, p. 29) - it would have to be explained why such a general preferential treatment of the import-competing activities at the expense of the exportables and the non-tradables sectors creates net economic benefits.

the early phase of the transformation process when these lobbies were still weak.

The instability (the lack of credibility) of the new liberal regime has at least one grave consequence. The benefits of liberalisation do not only spring from cheaper imports and from better conditions for selling the present quantity of exportables abroad but also, and more importantly, from a specialisation of production in line with the comparative advantages of the country concerned. The more potential investors anticipate that the liberal regime may not be durable, the more reluctant will they be to lock in resources into specific uses and the less will they invest in the restructuring of production.

In the same vein in which a unilateral adoption of Western institutional blueprints does not solve the credibility deficit of the new arrangements (see section 2), a unilateral commitment to free cross-border transactions does not suffice to make the new regime credible - which in turn is a precondition for reaping the benefits of such liberalisation. Ideally, the EMEs would need

- a way to turn the liberalisation progress which can be attained now into a lasting achievement (i.e. to make a liberal regime stable and credible) and
- the opportunity to deviate occasionally from the non-intervention rule in a way which is clearly temporary, cannot turn into permanent protection and does not cast doubt on the credibility of the commitment to a liberal regime.

This is exactly what joining the EC would mean for the EMEs. If the EMEs used their present scope for radical liberalisation to subject themselves lastingly to the EC discipline on external protection and internal subisidies, the final design of their external economic policy would not be in serious doubt anymore - at least as long as the assumption holds that the EMEs would be highly unlikely to incur the political, economic and perhaps even psychological costs of leaving the EC once they have got in. A treaty of accession could state that, during a transition period, the EMEs could temporarily introduce tariffs and/or subsidies which go beyond the EC norm. The precommitment to fully accept the EC discipline a few years hence lends credibility to the announcement that these measures will actually be phased out. In such a setting, a temporary protection is neither a deterrence of investment nor an incentive to lastingly devote new resources to sub-optimal uses.

While an outright accession to the EC is preferable for the EMEs on credibility grounds, it need not be the only option. For the EC, the admission of new members would further complicate the already quite arduous process of internal decision-making (and of agricultural reform). Hence, the EC may first need time to streamline and adapt its political institutions in such a way that a substantial enlargement does not impair the efficiency of EC decision making.[10)] Well-designed agreements of association could be a valuable intermediate step. If they are to impart almost as much institutional credibility on the EMEs as immediate EC membership would, such agreements would need to spell out that the EMEs will finally be admitted to the EC and to specify a date at which the EMEs become eligible for full membership. Such association agreements would be a close substitute for an immediate enlargement of the EC. Instant membership would anyhow entail a period of transition during which special arrangements would still apply for the EMEs.

The arguments presented above are essentially an application of the general point that Western European institutions have a comparative advantage in credibility, an advantage on which the EMEs could draw. With regard to a liberalisation of economic transactions between the EC and the EMEs, a closely related and theoretically interesting issue can be raised. Consider an asymmetric liberalisation between two countries, both of which had initially applied restrictions to their bilateral economic exchanges. Does it matter which of the two countries unilaterally

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10) The present negotiations on a political union might be a convenient opportunity for the EC members to do so.

lowers its barriers vis-a-vis the other one? According to standard trade theory, it does not make a difference who reduces the artificial transport costs (as long as it is done by a comparable magnitude): if these costs decrease, the structure of production will move closer to the free-trade pattern in both countries in a similar way.[11)] The same welfare-enhancing re-specialisation of production will materialize regardless of who did the liberalisation. This symmetry vanishes if the two countries are differently endowed with credibility. If the high-credibility country liberalises, the pattern of production would adapt; if the low-credibility country did the same, investors would take the possibility of a future reversal into account and invest less. In other words: the credible country has a comparative advantage in liberalisation. The reduction of barriers to international transactions of a comparable magnitude elicits a more positive response and contributes more to a specialisation in line with comparative advantages if it is undertaken by a country with a credible external economic policy. As long as a liberalisation of the EC vis-a-vis the EMEs would be more credible than vice versa,[12)] any asymmetry in liberalisation agreements between the EC and EMEs should be of the kind that the EC reduces its barriers to bilateral exchanges in advance of the EMEs.

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11) This presupposes that the liberalising country reduces all import barriers proportionately. The analysis abstracts from distributional issues, including those of the distribution of the additional gains from trade between the two countries.

12) The analysis is based on the assumption that the external economic policy of the EME is not (yet) as credible as that of the EC; either because the EME has not (yet) subjected itself to the EC regime or because the EME's commitment to lastingly accept the EC rigour is not entirely credible.

6. Monetary Stabilisation: A Role for the ECU

6.a. The Stock and the Flow Problem of Stabilisation

Macroeconomic stabilisation is one of the major tasks of the transformation process. It refers both to a stock problem, i.e. the elimination of an accumulated monetary overhang in those EMEs that have not yet "solved" the problem of this legacy by open inflation, and to a flow problem, i.e. the prevention of a further excess growth in the money supply.

By definition, the monetary overhang needs to be abolished by a reduction in the real money supply (relative to real GDP). This can be done via

- open inflation, which erodes the real value of a given nominal quantity of money;
- a genuine currency reform, which administratively reduces the value of monetary assets relative to flows (the most important example being that a part of the nominal quantity of money is cancelled at roughly unchanged prices); or
- an asset switch, which converts liquid assets into less liquid ones, for instance by adminstratively blocking money holdings or by converting money into tradable vouchers for the subsequent purchase of state property.

In terms of political feasibility, open inflation is the easiest and a currency reform the most problematic option; the latter (former) entails the most (least) visible form in which the state deliberately breaches the promise to honour its obligation vis-a-vis the holders of its money.[13] In terms of the

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13) In none of these options aggregate net wealth is created or destroyed relative to any other option. The major instant difference is distributional: who bears which part of the burden of the already existing monetary imbalance. In the case of open inflation, the burden falls disproportionately on those who keep a relatively high share of their overall wealth in monetary assets (often the low-wealth strata of society); in the case of a currency reform, this effect can be mitigated by a differentiation of the conversion rate; in the case of an asset switch, the losers are those economic agents who would otherwise

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repercussions on real economic activity, a sizeable increase in the price level is the most hazardous approach. The one-shot adjustment of prices may nurture inflationary expectations and ignite a continuous process of price increases which needs to be stopped by a tough stabilisation programme. With regard to credibility, both inflation and a currency reform may undermine whatever confidence the public may have in the monetary authorities. A currency reform, however, can comparatively easily be presented as a once-and-for-all and hence credible solution; especially if the old currency is replaced by a new one to symbolise the break with the past. A further advantage of a currency reform and an administrative asset switch over open inflation is that both can be carried out immediately while the adjustment of the price level needs time. With regard to monetary control in the first phases of stabilisation, a combination of a currency reform with an administrative conversion of some monetary excess balances into either tradable privatisation vouchers or equally tradable blocked accounts is preferable. With the currency reform, the initial quantity of money can be set at the desired level; thereafter, central bank purchases or sales of vouchers or blocked accounts (perhaps in public auctions) could serve to steer the development of monetary aggregates via an open market policy which otherwise could be conducted only in a very rudimentary form in the EMEs due to a lack of instruments and suitable institutions.[14)]

Once the stock problem has been solved, the flow problem is to maintain a non-inflation balance between monetary demand and aggregate supply. This necessitates an effective control over the

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have benefitted from the tax reductions (or the abandonment of plans to increase taxes) if the state had not issued vouchers for state property but had gained revenues from the sale of real assets; see also Hofman and Koop (1990).

14) An external contribution to the elimination of a monetary overhang could simply take the form of financial assistance so that part of the overhang could be converted in foreign currency or imported goods.

money supply in the sense that (i) the monetary authorities can actually determine the amount of central bank money (i.e. that government or even firms cannot directly or indirectly supply themselves with central bank money) and that (ii) the central bank has at least a rough idea about the velocity of money and the relation between the monetary base and broader monetary aggregates at any time in the transformation process. Because commercial banks exist only in a rudimentary form and because the experiences gathered under the old system are hardly relevant for the new regime, the latter problem is particularly difficult to solve. Hence, sticking to targets for narrow money is quite unappropriate. Unfortunately, as an autonomous internal monetary policy may have to be handled flexibly anyhow, it will be particularly difficult to achieve anti-inflationary credibility for such a seemingly volatile policy.

Even more important than the issue of an appropriate short-term monetary policy is the need for the government to conduct a fiscal policy that makes a monetization of any eventual debt highly unlikely. This will only be achievable if firms by and large have to get by without substantial state subsidies (or implicit or explicit credit guarantees) and are thus subjected to a hard budget constraint (to borrow a term from Kornai 1980).

6.b. Enhancing Monetary Credibility

The probability of success and the real economic costs associated (i) with combatting an inflation which has erupted when the discipline of the old regime broke down and (ii) with solving the flow problem of monetary stabilisation depend on the credibility of the new policies. Insufficient credibility of a policy of monetary and fiscal austerity has five awkward consequences:

(1) The more workers and managers of (state) firms expect future losses to be covered by state subsidies, the less incentive do they have to accept the wage restraint which is needed for a sustainable stabilisation; on the contrary, if they expect that government will not be able to prevent a substantial rise in

average wages and that at least some of the most unprofitable sectors will be subsidised, they will rationally want their sector to be among those sectors in which wage costs increase most; the result is a negative-sum game of a competitive rush for higher subsidies via higher wages.

(2) The less credible the monetary policy is, the more will domestic and foreign sources of credit stay dry or dry up; i.e. the more will government need either to run a balanced budget or to finance a deficit via the central bank.

(3) Monetary instability causes a sub-optimal degree of monetization and hence unnecessarily high transaction costs.

(4) For the same reason, real interest rates would be higher than otherwise; risk-averse lenders would demand a premium for macroeconomic uncertainties.

(5) The more unstable the general macroeconomic environment is perceived to be, the less may risk-averse foreign banks (and the nascent local ones) be willing and able to rapidly establish a highly differentiated and sophisticated banking system; such a delay would impair both the overall allocation of investible resources and the efficiency of monetary policy.

Externally, the problems of monetary stabilisation relate to currency convertibility and the exchange rate. An early transition to convertibility at least on current account has two advantages[15]:

(1) It removes the money-induced distortions in the price structure of tradables and hence in the relative profitability of producing goods and services that can be supplied to foreigners (including tourists).

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15) For a survey of the major issues see Portes (1991).

(2) It puts an end to money-induced restrictions on the competitive pressure which foreign suppliers can exert on domestic producers.

Naturally, both the price structure of tradables and the extent of foreign competition may still be affected strongly by non-monetary instruments such as tariffs, import quotas, subsidies and the like. And a "wrong" rate of exchange, while not affecting the relative prices within the tradable goods sector, would result in a "wrong" relative price between tradables and non-tradables.

External monetary policy involves choices on two (or three) issues, namely

- on the payments regime, i.e. on the extent of convertibility;
- on the exchange rate regime, i.e. on whether the exchange rate should be fixed, adjustable or free; and, if the exchange rate is not left free to float,
- on the exchange rate itself.

Sure enough, the issues of convertibility and the exchange rate are interrelated. The sustainability of convertibility hinges upon whether an exchange rate is correct or not; a chosen exchange rate may be defended for the time being by altering the degree of convertibility. With respect to credibility, there is a pay-off between between a commitment to convertibility (i.e. a commitment to a general regime) and a commitment to a certain exchange rate (i.e. a commitment to a specific policy parameter). In the extreme case in which the monetary authorities do not and will not care at all about the exchange rate (free floating), the commitment to convertibility is highly credible as - by definition - there could be no reason to introduce payments restrictions in order to defend a specific rate. And if the monetary authorities would only care about maintaining the exchange rate, they may resort to convertibility restrictions once the credibility of their commitment to that rate is tested, at least in the absence of very large funds for interventions in the free market.

The EMEs have no such funds to defend a fixed exchange rate that is deemed to be fundamentally correct but has come under short-term pressure. Neither do they have a reputation for monetary stability and for toughness on the threat of wage inflation. To be sustainable, the fixed exchange rate would need to be so credible as a nominal anchor that the behaviour of economic agents is changed so that the latter do not put the rate to the test by wage inflation. Given the lack of reputation and thus credibility, the likely outcome is that nominal wage cost cannot be hold completely in check; the resulting real overvaluation causes unemployment and a balance-of-payments crisis which ultimately triggers a nominal devaluation. As the commitment to the fixed rate has not been sustained, the credibility of the entire transformation programme suffers. This may still turn out to be the fate of the admirably courageous Balcerowicz programme in Poland.

Hence, a freely floating exchange rate seems to be the best means to sustain convertibility. Unfortunately, the rate could be highly unstable under unrestricted convertibility. Due to the lack of a domestic financial system, speculative private capital flows could not - or only to a small extent - smooth impending fluctuations in the exchange rate in the way they do between well-established market economies. A pronounced instability of the exchange rate, fuelled also by general political uncertainties, could easily translate itself into instabilities in the real economic sphere - and hence to a shortfall in investment and a misallocation of scarce capital.

The implications of both extreme approaches are quite unpalatable. Hence, if the EMEs are on their own, i.e. if they have to get by with minor foreign exchange reserves and their own low reputation, a crawling peg to a major Western currency appears to be the least risky foreign exchange regime. By opting for a crawling peg, the monetary authorities would refrain from using the exchange rate as a nominal anchor and from investing whatever reputation they might have into a commitment to a specific exchange rate. In order to be manageable and durable in the instable macroeconomic environment of the EMEs, the rate would have to be reassessed and if necessary readjusted frequently. Given the lack of large funds to smooth major short-term fluctuations of the market exchange rate, convertibility initially would have to be restricted to current account transactions. Capital flows would have to be controlled in order to avoid unsustainable short-term imbalances on the foreign exchange market.

The above analysis presupposes that the EMEs have to get by with their own resources; it applies to cases with starting conditions of low-credibility. Once again, the opportunity to draw on external support or even to take recourse to an external precommitment technology changes the picture. External support for making convertibility at a fixed exchange rate sustainable and hence credible could take four different forms:

(1) The standard approach for Western benefactors is to grant a convertibility fund, i.e. a line of preferential credit on which the country in question could draw to defend the exchange rate if it accepts some degree of supervision of its domestic economic policies. Such a supplement to domestic exchange reserves makes the commitment to maintain the exchange rate against short-term speculative attacks more credible; the rate (and the chosen degree of convertibility) become sustainable for a longer period of time. However, the ultimately decisive question is whether the provision of such a fund helps to exert disciplinary pressure on domestic wage costs in the EMEs. This need not be the case. On the contrary, economic agents may face perverse incentives. If there are external funds available at preferential terms, politicians and/or economic agents do best if they make themselves eligible for such support. In the extreme case, this may mean that politicians rationally relax whatever control they may have on wage costs in order to create the balance of payments deficit necessary to take advantage of the funds. More realistically, it may imply that the resolve of politicians to

resist such pressures is weakened[16)] - a point which workers may take into account when they ponder the probability of obtaining wage increases in the first place. And the foreign institutions which are supposed to supervise the monetary and fiscal policy of the EME are themselves in an awkward position. Having become entangled with the EME, they may be reluctant to concede failure - and rather opt for a continuation of support to an EME which has not lived up to the original expectations. After all, an international institution like any other rational bureaucracy may relish having permanent tasks to justify its existence and expansion (see also Vaubel 1983).

(2) An EME may import Western bankers with a conservative reputation to run the autonomous monetary policy of its new central bank (see also Rogoff 1985). This could help to make the policy credible, albeit only up to a point. The exit costs for the government, i.e. the costs which the government incurs if it fires these central bankers, are likely to be small; the smaller the punishment for defection, the less the gain in credibility. Furthermore, the Western central bankers who operate in an environment that differs substantially from that in the West may not be as tough on inflation as they were under much more convenient circumstances at home. Failure may not be very costly to them personally in terms of their domestic reputation. They could always claim that they were not given sufficient political backing by the government of the EME.

(3) To overcome their lack of credibility, the new monetary authorities in the EMEs may be designed in a way which dramatically curtails or even completely removes their freedom of manoeuvre. For example, an EME could opt for a currency board solution.[17)] Although the EME nominally maintains its separate

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16) Poland's pre-election relaxation of the monetary and fiscal reigns in the autumn of 1990 may be a point in case.

17) Currency boards used to be the rule for colonies in colonial

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currency, the money is so tightly linked to a (preferably rather stable) Western currency as to make it almost undistinguishable from the latter. The currency board issues a legal tender and guarantees to convert upon demand any of its coins, notes or its other liabilities into the anchor currency.[18] The board has almost no discretion in the conduct of its monetary policy; the money supply is solely determined by the balance of payments, as it is in any subregion of a currency area (for instance the city of Kiel in the case of the DM area).

The board derives the credibility of its commitment to maintain both full convertibility and the chosen rate by backing all its liabilities to at least 100 per cent by interest-bearing foreign exchange reserves in the anchor currency. If the reserves covered exactly the domestic liabilities, the board could convert the entire amount of central bank money into the anchor currency - but it could not do so for broader money aggregates, i.e. for the result of domestic credit creation. Hence, the board would not be able to fulfill one essential function of a central bank, namely that of acting as lender of last resort under extreme duress. The board could not counteract the contractionary effects of a run on banks (i.e. of a collapse in domestic credit creation) by increasing the amount of central bank money in circulation.[19] In order to be a reliable lender of last resort, the board would need a permanent reserve ratio well above 100 per cent - or the guaranteed opportunity to draw on foreign credits in case of a

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times. Today, two outstandingly successful countries of South East Asia - Hongkong and Singapore - still have monetary regimes which are or at least closely resemble currency boards. Furthermore, the French Franc zone comes close to such an arrangement. Its record of low-inflation is outstanding among developing countries; see Toporowsky (1990) who, however, criticizes the tight monetary and fiscal discipline to which the Franc zone subjects its African member states.

18) Currency board solutions have been proposed by Hanke and Walters (1990; for the former GDR) and by Steinherr (1991).

19) This seems to be the major reason why Bofinger (1991, pp. 25-26) dismisses the currency board option.

run. Such a guarantee could well be obtainable from Western central or even commercial banks. The supply of resources to counteract a run on banks would enable the EME to weather such a run without a contraction in the money supply - and hence without a secondary recession. Once the structure of the domestic demand for money has normalised, the currency board of the EME could easily repay the credit.

As long as the board operates, the government and the economic agents in the country have no way to lastingly appropriate these funds - in the same way as governments under the gold standard could not lay hands on the gold reserves of foreign countries other than by buying the gold for what it was worth. The currency board could potentially exert the desired discipline on local agents. It is far more credible than a simple (unilateral) peg to a Western currency - and has the additional advantage of allowing for convertibility on capital account.[20)]

If the EMEs were to opt for a currency board, Western support could take the form of a one-shot infusion of reserves to back the EME currency board. In this case, a gift of money could actually contribute remarkably to the process of erecting reliable institutions in the EMEs. The major problem with the currency board solution is that it is still a unilateral arrangement. It could be abrogated by the EME (or by Hong Kong for that matter) without reneging international agreements, i.e. without giving rise to external exit costs. Although the currency board has desirable features, it is hence not yet the optimum from the viewpoint of institutional stability and credibility.

(4) In order to partake fully in the proven credibility of a Western currency, the EMEs could completely surrender their monetary autonomy to a Western central bank by de jure or at least de facto adopting the Western currency. This could take

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20) Naturally, the problem of a monetary overhang would have to be solved before such a board is established.

different forms. On the one hand, the Western central bank to whose money the EME currency is to be pegged irrevocably could be appointed as manager of a currency board for the EME. On the other hand, the EME could simply introduce a Western currency as its legal tender, in the way in which the U.S. dollar is the currency of Panama.

The European Currency Unit would be the natural choice of an anchor currency for the EMEs for whom the external economic ties with Western Europe are by far the most important after the collapse of the erstwhile Council for Mutual Economic Assistance. If the ECU is to be the currency to which the EME money is pegged - or which is introduced outright in an EME - a common body of the EMS central banks might have to be created immediately to handle the task. This could imply a loss of valuable time on top of the political obstacles to be overcome as such an arrangement might be seen as prejudging some of those features of the future West European currency union on which the EC governments have not yet reached a consensus.[21)] However, the EMS governments might also entrust this task to the central bank of a member country (which need not be the Bundesbank).

The advantage of introducing a Western currency - instead of opting for an externally managed currency board - would be that the exit costs for the EME would be higher. Regaining autonomy would not only imply reneging international agreements. The EME would also have to introduce a new currency, which - as the examples of various republics striving to leave Yugoslavia or the Soviet Union shows - is not an easy venture. By proposing to the EMEs an international agreement on the de jure or de facto introduction of the ECU as the EME currency, the EC would in effect offer the EMEs the most efficient technology for making a

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21) Bofinger (1991); roughly in line with arguments made above, Bofinger - of whose contribution the present author became aware upon putting the finishing touches to this paper - advocates the transfer of monetary autonomy of the EMEs to a supranational institution.

credible precommitment to external and internal monetary stability, including the precommitment to full currency convertibility. This would have various important advantages.

(1) Most fundamentally, Western Europe would lend its monetary stability to the EMEs.[22] For this reason, the process of establishing a modern financial system would be much quicker and smoother in the EMEs.

(2) As the anti-inflation policy would be highly credible, the complete monetization of the economy would proceed rapidly and real interest rates would not contain an above-average premium for macroeconomic risks.

(3) For the same reason the EMEs would have scope for non-inflationary budget deficits, i.e. for deficits which up to a point would have no negative repercussions on macroeconomic stability. In other words: the EMEs could run such deficits at the time they need them most, namely in the social upheaval of the transformation process. If the shift from socialism to a market economy is sustained, it will ultimately result in a much more efficient allocation of resources and hence in much higher

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22) Note that this does not imply that the inflation rate in the EME will be similar to the one in Western Europe. Only the prices of tradables for which the law of one price by and large holds will develop in parallel. A process of above-average economic growth typically goes along with a revaluation in real terms as the prices for non-tradables rise relative to those for tradables. If catching-up countries are linked to countries with less growth via a fixed nominal exchange rate, the former will by necessity have a higher rate of inflation if price level changes are measured by indices which include non-tradables. The unwillingness of rapidly growing West Germany to permanently accept a higher rate of inflation than the low-growth US was a major reason why the Bretton-Woods system became unsustainable in the late 1960s. In the same vein, the strength of the Spanish peseta is presently a major strain on the EMS, although fast-growing Spain has an above average rate of inflation. Urging Spain to curb inflation to the EC average and to maintain the EMS parity at the same time is hence tantamount to asking Spain not to catch up to the richer countries of the EC.

GDP. Debt incurred to cushion the transformation crisis could hence easily be repaid a few years afterwards. Without ceding monetary sovereignity, the EMEs would not be able to attract sizeable private funds at the height of their crisis.

7. Lessons from the East German Counterexample

This paper has argued that the EMEs would benefit substantially from integration with Western Europe. Unfortunately, the experience of East Germany seems to indicate the opposite. The very region of the former socialist camp which by courtesy of German unification adopted wholesale the institutions and the currency of a successful West European country was hit by the worst case of an adjustment crisis. In terms of the stability and credibility of its new institutional framework, East Germany is in a different and seemingly much more advanced league than all other countries in transformation to a market economy. Are the arguments presented above invalid - or were special factors at work which more than compensated for the institutional advantages which East Germany could enjoy?

With respect to monetary stability, East Germany has fared well. Inflation is negligible by the standards of other ex-communist regions, the banking system has developed rapidly. The reasons for the East German slump lie largely in the substantial increase in production costs (Schmieding 1991a). Based on what is admittedly only an imperfect yardstick - the domestic resource costs of earning one DM in exports - the former East German mark was worth only 23 West German pfennigs. Hence, the 1:1 conversion rate for current payments in the currency union of July 1, 1990 caused a dramatic overvaluation of East German output. And fuelled by political promises to quickly narrow the gap in living standards between East and West Germany and to provide subsidies for this purpose, East German wages have risen substantially since the currency union. The East German case shows what may happen in free wage bargaining between trade unions and managers of state-owned firms who have little personal incentive to care for profitability.[23)]

By now, wages in East Germany are roughly six times as high as those in Czechoslovakia. The high level of labour costs renders almost the entire tradables production in East Germany unprofitable (Akerlof et al. 1991). Furthermore, almost all the intricate complexities of West German laws and regulations have been introduced in East Germany. These administrative hurdles to flexibility and investment considerably impair the rebuilding of the East German economy.

The East German experience points to three rather simple lessons:
(i) a gross overvaluation ought to be avoided;
(ii) a relaxation of wage controls for state-owned firms may initiate a wage explosion, especially if workers have reason to assume that generous subsidies will be forthcoming; and
(iii) the EMEs would be ill-advised to immediately adopt all the complicated details of Western laws and regulations.

The last point is of considerable importance in the context of this paper. Upon establishing formal institutional links with the EC, the EMEs need the opportunity to opt for a considerably simplified and liberalised version of the EC laws and regulations, i.e. for the basic content but not necessarily for

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23) The standard argument that actual or impending migration triggered the East German wage explosion appears to be superficial. It would imply that the dismal outcome is the result of a well-functioning labour market - with wages reacting in a textbook manner to an actual (or impending) decrease in labour supply. However, if profit-maximising (or loss-minimising) firms had granted higher wages in order to prevent the outmigration of valuable workers, these wage increases would not have caused unemployment. Firms would have offered higher wages only to the extent that the wages do not exceed the marginal productivity of the (remaining) workers. As post-CU wages are far above productivity - apart from a few subsegments of the labour market for people with exceptionally scarce skills - no rational firm has an incentive to prevent its workers from going West, least of all by offering higher wages.

the complicated details of these arrangements. Such a solution need not be restricted to a period of transition. Instead, it could constitute a major step towards a lasting deregulation within the EC.

8. On the Importance of Speed

For the EMEs, the institutional void which characterizes the first phase of the transformation process presents a grave hazard and a splendid opportunity at the same time. The hazard is obvious: the length and depth of the transformation crisis in the EMEs depend on the rapid emergence and on the credibility and stability of the new and market-conformable institutions. If the transformation process founders because of the lack of firmly entrenched institutions, the Central and East European states may in the worst-case scenario go down the slippery road towards the awkward political authoritarianism and the stiffling economic interventionism which was the hallmark of major parts of Latin America in the past decades (this spectre was raised i.a. by The Economist 1990). The corresponding opportunity is enticing: as the old system had shaped almost every aspect of the body politic and the body economic, its collapse has created a situation which may be as close to an institutional vacuum as mankind may ever get. The spontaneous emergence and the conscious design of new institutions thus face comparatively few restrictions. In a similar vein, the weakness of the previous elites and of the nascent new distributional coalitions facilitates the choice of coherent first-best solutions.

The later strong institutional links between Western Europe and the EMEs are created, the greater the hazard that the emerging special interest groups in the EMEs will successfully thwart attempts to implement efficient solutions. The sooner Western Europe finds ways to lend institutional stability and credibility to the countries in Central and Eastern Europe, the more could this help the EMEs to rapidly overcome their present transformation crisis and to finally catch up with the West.

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